Economic Trends

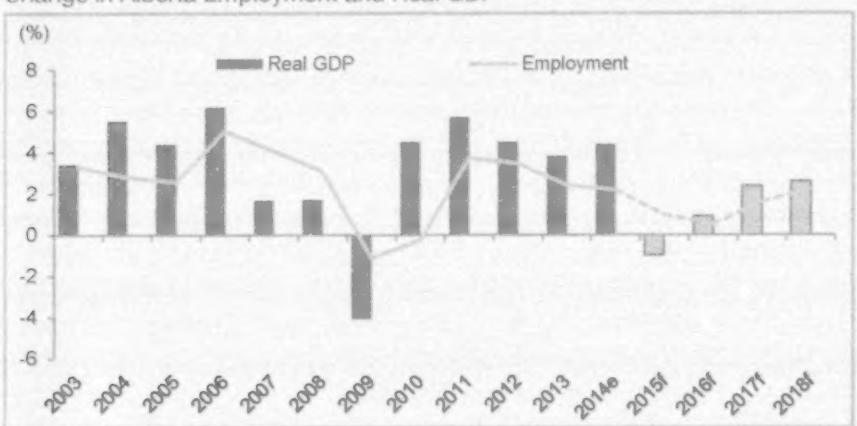
Alberta economy adjusts to lower oil prices

This month's trends is taken from the Economic Outlook chapter of Budget 2015: Supporting Jobs, Supporting Families, released on October 27, 2015.

Summary

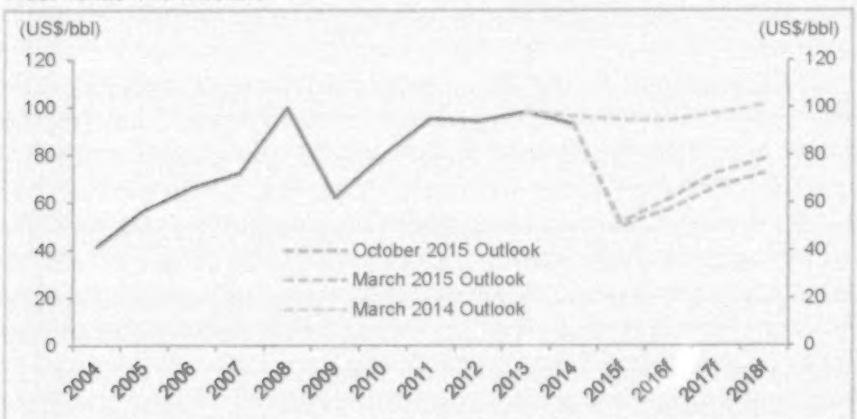
After a mild recession in 2015, Alberta's economy is expected to see a modest recovery in 2016 and improve over the medium term. Real GDP is estimated to contract 1.0% in 2015, due to the collapse in oil prices and drop in energy investment. Corporate profits and Government of Alberta revenue will be hit particularly hard by the weaker outlook for oil prices.

Chart 1: Economy to pick up after contracting in 2015
Change in Alberta Employment and Real GDP



Sources: Statistics Canada, Alberta Treasury Board and Finance. e-estimate, f-forecast

Chart 2: The outlook for WTI has weakened
West Texas Intermediate



Sources: Alberta Energy, f-forecast

The economy is forecast to expand in 2016, but at a relatively slow pace of 0.9%, reflecting the lagged effects of lower oil prices on employment, housing and consumer spending. In 2017 and 2018, growth is expected to accelerate to around 2.5% (Chart 1), supported by gradually rising oil prices, weaker cost pressures, a stronger US economy and a low Canadian dollar. Following years of large-scale investments, Alberta's economy will continue to increase production and transition to export-led growth. Increased spending announced in the Capital Plan will also provide a boost to real GDP and employment growth.

Employment has been resilient despite energy-related job losses, with average annual job growth of 1% expected in 2015. The labour market will weaken further in 2016 before improving in 2017 and 2018.

The current recession will not be as deep as the previous one in 2009. Momentum in the Alberta economy heading into 2015 tempered the effects of the oil price correction. Construction outside the energy sector has remained solid and households will contribute to growth as the population expands. Rising oil sands production and a weaker Canadian dollar have supported exports, partially offsetting the impacts of lower oil prices.

Alberta Business Sector

Low oil prices have forced producers to reduce capital spending, slowing oil-related activity. Capital spending is expected to decline further in 2016 before gradually recovering. Expanding oil sands production will continue to drive exports. Other sectors will benefit from improved labour availability and reduced costs, along with a weaker dollar and strengthening US economy.

Tempered outlook for oil prices

Ample supply from both OPEC and non-OPEC sources and uncertainty about global growth and oil demand have dampened the oil price outlook over the medium term. WTI is expected to average US$50/bbl in 2015-16 and increase to around US$68/bbl by 2017-18, significantly below price levels seen in the past four years (Chart 2).

Strong demand for heavy crude and improved market access are supporting heavy crude oil prices. Producers have benefited from a narrower light-heavy oil price differential, which is expected to average US$13.60/bbl in 2015-16. Over the next few years, however, oil sands production is expected to rise faster than available pipeline capacity, increasing reliance on rail. This will cause the differential to widen to US$18.50/bbl by 2017-18.

Extended weakness in energy investment

Lower oil prices are significantly reducing corporate profits. Net operating surplus, a measure of profits, is expected to fall 55% in 2015. The moderating outlook for energy prices and economic activity means that profits are not expected to return to 2014 levels over the forecast period. Oil producers have responded by cutting capital investment by an estimated 34% in 2015. Capital spending is expected to contract again in 2016 by 4.2%, before returning to annual growth of 4-5% in 2017.

The short life cycle of conventional oil and gas investment makes it more sensitive to the near-term price outlook. As prices improve in 2016, conventional investment is expected to begin recovering and grow by around 6% per year in the medium term.

Oil sands investment will also decline, but by less than conventional investment. This is because oil sands projects have long life cycles and most have already committed large amounts of capital. Oil sands investment is estimated to decline 23% in 2015 and around 10% in 2016 before increasing.

Non-energy construction resilient

Outside the energy sector, investment will continue to expand over the forecast period. Construction activity has remained solid so far in 2015, reflecting the need to catch up after 3 years of record in-migration and economic growth. Permits suggest, however, that commercial and industrial construction activity will start to slow as current projects wrap up. Exceptional population growth has increased the need for public infrastructure. Plans by the government to bolster capital spending during the downturn will partially offset the decline in private construction in the next few years.

Oil production continues to rise

Despite lower oil prices, oil production in the province will continue to expand. After several years of large scale investment in the oil sands, new projects will add over 500,000 barrels per day of production over the next three years. Towards the end of the forecast horizon, production growth will be slower than previously expected because of lower investment and project delays in 2015 and 2016. Conventional oil production will continue to decline, but it now represents less than 20% of Alberta's total oil production. Oil export volumes are expected to increase around 5% per year over the forecast period, adding significantly to overall exports and economic growth.

Non-energy production to bounce back

For sectors outside of energy, 2015 growth expectations have been somewhat muted. Manufacturing has been hurt by lower oil and gas activity, while the agriculture sector has been hampered by drought conditions. Over the forecast period, however, these industries will benefit from a lower Canadian dollar, declining cost pressures, and a strong US economy.

The downturn in drilling across North America has dampened demand for Alberta-made industrial machinery and equipment. Manufacturing exports are estimated to decline 2.6% in 2015. Starting in 2016, however, manufacturing exports are expected to rebound, growing 2-4% per year.

In the agriculture sector, drought conditions adversely affected Alberta crop production this year. Crop prices are up in 2015, but large global grain inventories will weigh on prices heading into next year. Lower prices and volumes will negatively impact exports

Chart 3: Investment to improve slowly
Change in Alberta Public and Private Non-Residential Investment

Source: Statistics Canada, Alberta Treasury Board and Finance. e-estimate, f-forecast

in 2016. Cattle producers continue to reap the benefits of higher prices, but exports of live cattle are forecast to decline this year and in 2016 due to a smaller calf crop and lower inventories.

Expansion in the food manufacturing sector has increased local demand for agricultural products. Prospects remain encouraging beyond 2016, with growth and increased trade expected in Alberta's agriculture sector.

The forestry product sector should continue to expand, aided by a weaker dollar, stronger US housing activity, and continuing demand from Asia. Alberta's softwood lumber production was up in 2015.

In the tourism sector, visits to Alberta's national parks are up about 10% and occupancy rates at resorts are higher so far this year, providing a lift to the tourism sector. There has been a drop-off in business-related travel, with hotel occupancy rates down in Edmonton and Calgary.

In the transportation sector, there is a need to expand capacity to support Alberta's rising production. The transportation and warehousing sector has seen exceptional growth in recent years, with investment almost doubling to $9.2 billion between 2012 and 2015.

Given the production profile of the oil sands, there is a need to build and expand the pipeline infrastructure.

Energy producers require improved access to international and coastal markets to support growth. This should support continued investment in the transportation and warehousing sector over the medium term.

Cost pressures easing

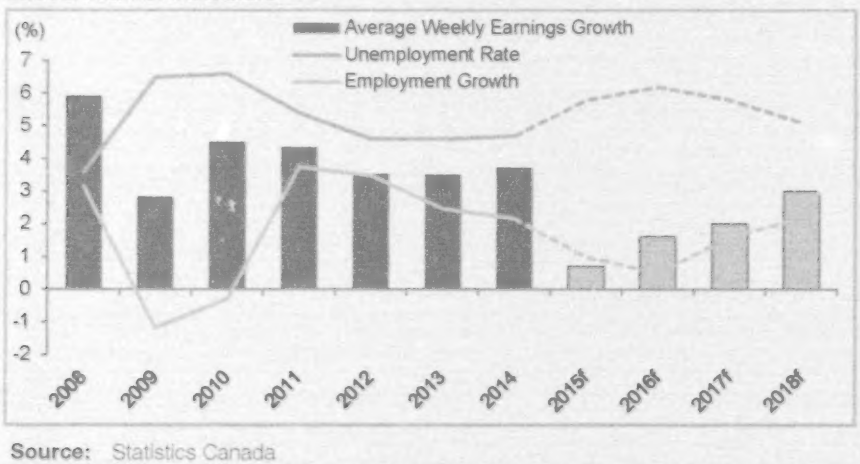
Cost pressures have started to subside with the decline in investment and activity. The slower pace of activity has forced companies to reduce labour costs and find savings from contractors. As the Alberta economy re-balances and the labour market cools in the next few years, industries stand to benefit from lower cost pressures.

Household sector

Households will continue to feel the effects of lower oil prices in 2015 and 2016 as the labour market cools and consumer confidence remains low. Continued population growth, low interest rates, and an improvement in business activity will support growth in household spending over the medium term.

Chart 4: Labour market conditions in Alberta weaken

Labour Market Indicators



Source: Statistics Canada

Labour market slowing with a lag

Employment has been stronger than expected so far this year, as gains in services have offset losses in energy-related industries. This reflects the significant amount of momentum in the labour market from 2014. Some businesses have used the slowdown to fill existing vacancies, while on-going projects have supported overall employment. In addition, job losses may be occurring in Alberta's large non-resident population, including fly-in/fly-out and camp workers, which would impact employment numbers in other provinces. Recent indicators suggest that Alberta's labour market is softening, with employment not keeping pace with the province's expanding labour force. Since early 2015, the unemployment rate has risen and EI claims have jumped. Overall, employment growth is expected to average 1.0% in 2015.

As momentum fades and energy investment remains weak, employment growth will slow to just 0.5% in 2016. The unemployment rate is expected to average 6.2% in 2016, up from 5.8% this year. Employment will begin to recover with broader economic activity beginning in 2017, with the unemployment rate gradually improving to 5.1% by 2018. Budget measures, including increased capital spending and the Job Creation Incentive program, will support the labour market over the forecast period.

Growth in household income, a key driver of personal income tax revenue, is forecast to slow from an average rate of nearly 8% over the past three years to 2.5% in 2015 and 2.8% in 2016. In the medium term, an improving labour market will support household income growth of 5% by 2018.

Population growth moderating

Alberta's population will continue to expand amidst the economic slowdown, albeit at a slower rate. Net in-flows of interprovincial migrants are not expected in 2016 and will remain

below recent norms in the medium term. Immigration, which is slower to react to economic changes, will be a source of growth, but changes to the federal Temporary Foreign Workers program will contribute to net outflows of non-permanent residents for the next two years. Natural increase will remain an important driver of Alberta's population.

Consumer spending slows

Lower growth in personal income and uncertainty about the economy have prompted households to rein in spending in 2015. Falling sales of motor vehicles indicate that households may be deferring large purchases until conditions improve. Growth in real consumer spending is expected to moderate, but still remain positive in 2015, at 1.3%. This compares to around 4% growth over the past five years. Continued population growth, improving labour markets, and relatively low interest rates will lift consumer spending up to 2.5% by 2018.

Low energy prices have helped keep a lid on inflation, which is expected to be 0.9%in 2015. It is forecast to pick up to around 2.0% over the medium term.

Home construction to slow Residential construction activity has been robust so far in 2015, in contrast to the resale market, which declined sharply early in the year. In 2014, housing inventories were low and the rental market was tight, reflecting the need to catch up after 3 years of record net migration. Housing starts in the first three quarters of 2015 were almost 39,000 (annualized), led by a surge in multi-unit starts. Starts are expected to be lower in 2016 and 2017 before rising again in 2018. Low interest rates will support housing over the forecast period.

Global Economy

Global economic growth remains sluggish in 2015 and prospects are not much better in 2016. Growth of just over 3% is forecast in both years. Continued improvement in the US economy is expected in 2016, but China's economy will slow further, weighing on commodity prices. With growth weak and inflation low, interest rates are likely to stay lower for longer.

Canadian economy slows

The Canadian economy has been hurt by low oil prices with real GDP expected to grow by only 1% in 2015. Growth is forecast to pick up to 2% in 2016 and remain there over the medium term.

The collapse in commodity prices has caused Canadian growth patterns to change. After leading the country for several years, resource-based economies of Alberta, Saskatchewan and Newfoundland and Labrador will all slow significantly in 2015, with weakness carrying into 2016. A stronger US economy and lower Canadian dollar have improved the prospects for the other provinces in 2015 and 2016, though not enough to offset a softening outlook for resource-producing provinces.

Risks to the Outlook

Oil prices are forecast to improve gradually. A further drop in oil prices could arise from weakening global demand or a slow supply response to low prices. Should low prices persist or fall further, Alberta's outlook would weaken.

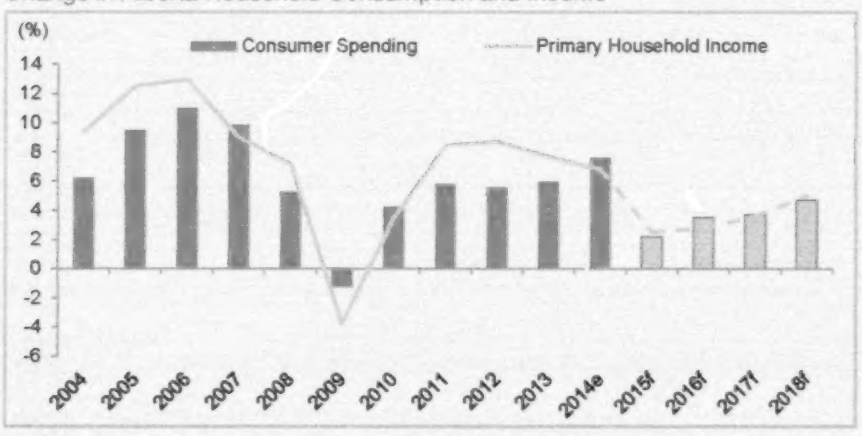
Emerging economies remain vulnerable to financial market shocks, as concerns remain about financial stability and overall growth prospects. A further slowdown in these markets would weigh on commodity prices, hurting Alberta's growth prospects.

Lower-than-expected migration poses downside risk to Alberta's economy. This would weigh on housing and consumer-related activity, slowing the province's growth.

Without improved market access, Alberta oil producers could see the return of large and volatile price discounts.

On the upside, an improvement in oil prices would improve Alberta's growth prospects. This could come from stronger global economic growth, supply outages due to political instability, or a move by OPEC to reduce supply and support prices.

Chart 5: Consumers keep spending, but at a much slower rate
Change in Alberta Household Consumption and Income



Source: Statistics Canada, Alberta Treasury Board and Finance, e-estimate, f-forecast.

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